

Taxes—New Case of Successful Family Limited Partnerships

The IRS continues to attack family limited partnerships (FLPs), often arguing that, notwithstanding the partnership structure, the decedent has retained an interest in the underlying partnership interests under IRC Section 2036. Consequently, so the argument goes, the assets should be includible in the gross estate at full fair market value.

Hope for Taxpayers

Several recent cases have taken on this issue with at least some of them favoring the taxpayer. The most recent of these cases is *Estate of Charlene B. Shurtz v. Commissioner*, TC Memo 2010-21. Read carefully, the case is a primer of “dos and don’ts” for the wealth manager seeking to take advantage of discount planning with FLPs.

The Facts

Charlene Shurtz, along with her two siblings, inherited from her parents interests in a family business. Charlene and her husband were religious and charitably inclined, spending time abroad as missionaries and donating almost \$1 million to charity.

As the family grew and more individuals owned interests in the business, it became increasingly difficult to manage the property. The family decided to streamline management and form a limited partnership to operate the business. Accordingly, C.A. Barge Timberlands, L.P. (Barge) was formed on June 25, 1993 and funded with 45,197 acres of Mississippi timberland.

Still concerned about centralizing management, Charlene was advised that each sibling should set up a second limited partnership for his or her family to hold their interests in Barge. As a result, potential creditors wouldn't have a right to the underlying timberlands, but only to the distributions actually made by Barge.

Charlene continued to directly own almost 750 acres of timberland that she wanted to give to her children and grandchildren. Because the difficulties in managing property with multiple owners was already clear from past experience, Charlene decided to contribute these lands as well as her interests in Barge to her new “upper tier” partnership.

Charlene and her husband each received a one percent general partnership interest and Charlene received a 98 percent limited partnership interest in the newly formed Doulos L.P. The partnership prohibited outsiders from becoming partners without the consent of the general partners and required outsiders who received partnership interests through involuntary transfers and spouses who held interests after the divorce or the death of an existing family member to sell such interests back to the partnership. Charlene made gifts of limited partnership interests to her children and grandchildren over the years as annual exclusion gifts.

The Issue

On Charlene's death on Jan. 21, 2002, she owned a one percent general partnership interest and an 87.6 percent limited partnership interest in Doulos L.P. The IRS argued that the value of the underlying assets Charlene contributed to the partnership, rather than the partnership interests, should be included in her gross estate under IRC Section 2036. The estate argued that Section 2036 did not apply for the reason that the formation of the partnership fell under the “bona fide” sale exception.

The Court’s Holding and Rationale

The court held in favor of the taxpayer, saying that the transfers to the FLPs met the bona fide sale exception of IRC Section 2036(a), citing *Estate of Bongard v. Comm'r*, 124 TC 95 (2005) and *Estate of Mirowski v. Comm'r*, TC Memo 2008-74.

Mirowski is important because it held that as long as estate tax savings is not the predominant reason for establishing the partnership, a finding that the taxpayer was motivated to reduce estate tax does not preclude the bona fide sale exception from applying.

And while tax savings did enter into the equation in *Shurtz*, the court found that Charlene and her family had legitimate and significant non-tax reasons for establishing the partnership.

- First, they sought to protect the family business from intra-family creditors and potential lawsuits.

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Taken together, these restrictions on control and marketability led to significant discounts.

- In addition, in light of Charlene's intent to give partnership interests to her children and grandchildren, forming the FLP would streamline the management of the property, which required active management. The court noted that management efficiency may be a legitimate and significant non-tax reason for establishing a partnership even if only a portion of the partnership property requires active management.

The court found also that Charlene had received full and adequate consideration in exchange for her interest because she and her husband received interests in the partnership proportionate to the property they contributed, the assets each contributed were properly credited to their capital accounts, and later distributions reduced each partner's capital account accordingly (even though distributions had been made that were not pro rata and make-up distributions were made afterwards).

The partnership was formed in a manner similar to the way in which ordinary parties in a business transaction would deal with each other, that is to say, at arm's length. Because the bona fide sale exception applied, only the value of the partnership interests were included in Charlene's estate. The limited partnership interests were entitled to significant discounts due to lack of control and lack of marketability.

Bottom Line

The *Shurtz* case is particularly interesting for two reasons:

- First, the court has interpreted *Bongard* to mean that estate tax savings, as long as it's not the predominant factor, can be a factor motivating the formation of a discount FLP and the tax-savings motivation will not necessarily prevent the formation of the partnership from qualifying for the bona fide sale exception.
- Second, while facilitating gift giving may not be a legitimate and significant non-tax reason, if a gift-giving program would create a difficult management situation for property that requires active management, improved management efficiency could still be a convincing legitimate and significant non-tax reason for forming the FLP.

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